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Abstract: Many of the new member states as well as candidate and accession countries of the EU are confident that membership will result in substantially increased inward foreign direct investment (FDI) in manufacturing. This paper discusses the policy issues and challenges that cohesion and accession countries face, applying lessons that by now have become mainstream in the parallel discussion of FDI-assisted development in the developing economies. We argue that globalisation has attenuated the benefits that accrue from EU membership for latecomers, and they must now compete for FDI not just with other European countries but also with non-EU emerging economies. We posit that they should not base their industrial development strategy on mere passive reliance of FDI flows without considering how to concatenate their industrial development and the nature of the MNE activities they attract.

Keywords: FDI, EU, multinationals, absorptive capacity, globalization, development, enlargement

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Introduction

Policy makers in most European countries consider inward foreign direct investment (FDI) as an indispensable part of their industrial development strategy. Many of the less economically developed, more 'peripheral' economies of the EU-15, such as Greece, Spain, Portugal, Ireland (referred to here as the 'cohesion' countries) followed this approach, and, partly as a result of their success, these policies have been pursued much more explicitly by the new member states (NMS) and those wishing to join, a large number of both groups being located in central and eastern Europe (CEE) (referred to in this paper either as the accession countries or CEE countries, irrespective of their membership status). Although this paper focuses on the accession countries as a group, we acknowledge that this classification subsumes important differences between several subgroups which are themselves made up of heterogeneous countries. Important subgroups include the 12 new member states, which joined in 2004, the two new members which joined in 2008, namely Bulgaria and Romania, and other candidate countries such as Croatia or Turkey. However, our aim is to discuss the broader aspects of the role of FDI in industrial development the principles of which, in our estimation, are broadly similar and relevant to all countries, rather than particular aspects and policy implications for individual countries. This paper will discuss the costs, benefits, opportunities and limitations of an FDI-based industrial development strategy in these countries.

The literature on FDI-assisted development is one which has evolved much more thoroughly in the context of developing countries (see contributions to Narula and Lall 2006 for a review) and to which Sanjaya Lall was a seminal contributor for much of his career. Many (but not all) of the challenges that face the peripheral economies of Europe in pursuing an FDI-based industrial policy have increasingly much in common with those that many developing countries have faced in the past, although cross-fertilization between the two literatures has been sparse.

We will attempt to raise some of the most important of these issues that derive from Sanjaya's work over the years[1], at the same time framing these within the context and particular challenges that derive from EU integration. We will focus on discussing the policy issues and challenges that face accession and cohesion countries, applying lessons that by now have become mainstream in the parallel discussion of FDI-assisted development in the developing world. Our attention will primarily be on FDI in the manufacturing sector, despite the fact that a large share of FDI in the accession countries is carried out by and in the services sector of the countries in question. However, despite its smaller share it has considerably greater economic and political significance for at least two reasons. First, the manufacturing sector tends to be regarded as more significant in terms of its potential to promote economic growth through spillovers and externalities. Second, a substantial part of the demand for services is derived demand from manufacturing activities (i.e. producer-related services such as banking, consulting, R&D, design).

This paper discusses the policy options of cohesion, accession and candidate countries for FDI-assisted development strategies in the light of the ongoing enlargement process of the European Union.

Some stylised facts about FDI-assisted development strategies FDI

Although inward FDI does not represent the only option available to promote economic catching-up, it may represent the most *efficient* option (Dunning and Narula 2004). FDI, however, is not a *sine qua non* for development. There are at least four main preconditions that need to be satisfied:

1. The kind of FDI being attracted must generate significant spillovers.
2. The domestic sector needs to develop the capacity to absorb these spillovers.
3. The FDI that is being attracted should be complementary to domestic industry rather than substitutory.

[1] We have not attempted to thoroughly reference each and every idea to specific contributions of Sanjaya Lall – given his prolific output over the years, the richness of his contributions and the seminal nature of his much of his work; this would make the paper unduly long. His contributions have played such an important part in this field that it has become almost impossible to distinguish his contributions from the contributions of those whom he has influenced.

4. A regulatory and institutional environment must be developed in order to facilitate the integration of the foreign affiliates into the domestic economy.

These conditions tend to make FDI more sticky and sustainable in particular locations. It is true that the determinants of economic development are similar to the determinants of FDI, but this does not mean that there is a simple cause and effect between them. Particular types of FDI tend to be attracted to countries with certain levels of economic development and appropriate economic structures. But simply to 'pump' a country full of FDI will not catapult it to a higher stage of development. In other words: there are no *automatic* gains from FDI (see e.g. Mencinger 2003). For instance, FDI may not compensate for the low ratio of domestic savings in the host countries; nor do we know whether inward FDI will generate sufficient externalities.

We highlight two points about the significance and nature of the positive externalities of FDI. First, even if FDI were attracted through large subsidies it is unlikely to become embedded, or provide significant externalities and spillovers to the host economy without the appropriate domestic absorptive capacity (Criscuolo and Narula 2008). From a developmental perspective, externalities only matter if they can be captured by other economic actors in the host economy. For externalities to be optimally utilised there needs to be an appropriate match between the nature of potential externalities and the absorptive capacities of domestic firms. It is ironic that the countries that receive the kinds of FDI that has the highest potential benefits vis-à-vis industrial development are those that already have a highly developed domestic absorptive capacity. In other words, domestic capacity – whether in the form of knowledge infrastructure or an efficient domestic industrial sector – remains a primary – and crucial determinant of high competence foreign affiliates (Radosevic 1999, UNCTAD 2005, Barnes and Lorentzen 2006). One of the most important lessons from Lall's work has been his emphasis on the failure by governments to promote their domestic sector when focusing on attracting MNEs as the primary aspect of their industrial development strategy. If no viable domestic sector were to exist, by definition, spillovers from FDI are largely irrelevant[2]. Even where a domestic sector does exist, this does not mean that MNEs will

[2] Empirical evidence for the CEE countries is provided by Konings (2001) and Nicolini and Resmini (2006).

necessarily establish links with them - in a perfectly liberalized world where market failures are minimised, MNEs have the capacity to bypass domestic firms completely. They can do so by either importing all their inputs, or by encouraging their captive suppliers from abroad to relocate.

*** FIGURE 1 ABOUT HERE***

Second, not all FDI is equal in the nature of the benefits it provides (Lall and Narula 2006). The quality of the spillovers that derive from an investment are associated with the scope and competence level of the subsidiary, and these are co-determined by a variety of factors (see figure 1). These include MNE internal factors such as their internationalization strategy, the role of the new location in their global portfolio of subsidiaries, and the motivation of their investment, in addition to the available location-specific resources which can be used for that purpose (Benito et al 2003). High competence levels require complementary assets that are non-generic in nature and are often associated with agglomeration effects, clusters, and the presence of highly specialized skills (Lall and Pietrobelli 2002). In other words, firms are constrained in their choice of location of high competence subsidiaries by local resource availability. For instance, R&D activities tend to be concentrated in few locations, because the appropriate specialized resources are associated with only few locations. The embeddedness of firms is often a function of the duration of the MNEs' presence, since firms tend to build incrementally. MNEs most often rely on location advantages *that already exist* in the host economy, and deepening of embeddedness occurs generally in response to improvements of the domestic technological capacity. However, while the scope of activities undertaken by a subsidiary can be modified more or less instantly, developing competence levels takes time. MNE investments in high value-added activities (often associated with high competence levels) have the tendency to be 'sticky'. Blomstrom and Kokko (1997) suggest that some of the host country characteristics that may influence the extent of linkages – and thereby in the longer term the extent of spillovers – are market size, local content regulations and the size and technological capability of local firms. They argue that there is a propensity for linkages to increase over time, as the skill level of local entrepreneurs grows, new suppliers emerge and local content increases.

In other words, government incentives and subsidies are rarely pivotal in determining the scope and competence of MNEs (which normally imply greater potential for greater technological spillovers). MNEs do not make their proprietary assets available at the whims of governments. Instead, they tailor their investment decisions to existing market needs, and the relative quality of location advantages, but especially the skills, capabilities and infrastructure in which the domestic economy has a comparative advantage. It is also clear that the kind of FDI activity a country might attract (or wish to attract) are different at different stages of its industrial development (Dunning and Narula 1996, 2004; Boudier-Bensebaa 2008). The motive of the investment is crucial in determining the extent to which linkages and externalities develop. The motive of an investment helps to determine (in conjunction with the host-country specific factors) the kind of MNE affiliate and therefore the potential for spillovers. It is generally acknowledged that there are four main motives for foreign investment: 1) to seek natural resources; 2) to seek new markets; 3) to restructure existing foreign production through rationalization and 4) to seek strategically related created assets. These in turn can be broadly divided into two types. The first three represent motives which are primarily asset-exploiting in nature: that is, the investing company's primary purpose is to generate economic rent through the use of its existing firm-specific assets. The last is a case of asset-augmenting activity, whereby the firm wishes to acquire additional assets which protect or augment their existing created assets in some way. In general, developing countries are unlikely to attract much asset-augmenting FDI, but tend to receive FDI that is primarily resource-seeking, market-seeking or efficiency seeking. Empirical evidence (e.g. Bellak et al. 2008a) shows that in the CEE countries, besides market size the level of infrastructure plays a crucial role for attracting FDI, while unit labour costs are comparatively less important.

*** FIGURE 2 ABOUT HERE***

The point here is that not all affiliates provide the same opportunity for spillovers. A sales office or an assembly unit may have a high turnover, employ a large staff, but the technological spillovers will be relatively fewer than, say, a manufacturing facility (figure 2).

Likewise, resource-seeking activities can be capital intensive, but also provide fewer possibilities for spillovers than say, a market-seeking type of FDI. Prior to economic liberalization and EU integration, MNEs responded to investment opportunities primarily by establishing truncated miniature replicas of their facilities at home, although the extent to which they are truncated varied considerably between countries. The extent of truncation was determined by a number of factors, but by far the most important determinant of truncation - and thereby the scope of activities and competence level of the subsidiary - were associated with market size, and capacity and capability of domestic industry (Dunning and Narula 2004). There is thus a hierarchy of the quality of FDI activity in Europe which reflects the stage of industrial development. At the 'bottom' are countries that are at an early stage of transition (and furthest away from convergence with the EU norm), with a very limited domestic sector and with low domestic demand. Such countries have been host to the most truncated subsidiaries, often single-activity subsidiaries, primarily in sales and marketing, as well as natural resource extraction. The most advanced economies with domestic technological capacity (such as the core EU members) have hosted the least truncated subsidiaries, often with R&D departments. Cohesion countries (with the exception of Greece) have been in the middle.

Miniature replicas are increasingly a concept of the past, particularly within the EU. Rationalisation of activities within the single market has, in many cases, led to a downgrading of activities from truncated replica to single activity affiliates. MNEs have taken advantage of the EU single market to rationalize production capacity in fewer locations to exploit economies of scale at the plant level, especially where local consumption patterns are not radically different to justify local capacity and where transportation costs are not prohibitive (i.e., there is a proximity – concentration trade-off). This has meant that some miniature replicas have been downgraded to sales and marketing affiliates, which can be expected to have fewer opportunities for spillovers.

To what extent the accession countries will be able to benefit from an increase in the quality of FDI that they receive due to EU membership, is an open question. Although there will be some investment in *new affiliates* resulting in new (greenfield) subsidiaries that did not exist

previously, there will also be a *downgrading of subsidiaries* (as discussed above). MNEs may divest their operations in response to better location advantages elsewhere in the EU (as Spain and Portugal are experiencing as their low cost advantages are eroded), or reduce the intensity of operations by lowering the level of competence and/or scope of their subsidiary, and shifting from truncated replicas to single activity affiliates. There may also be a *redistribution effect*. That is, sectors that were dominated by domestic capital are transferred to foreign ownership, particularly where domestic capitalists have failed to improve their competitive advantages to compete effectively with foreign firms. Indeed, in many of the CEE countries the share of foreign ownership in total capital stock is already typically much higher than in older EU member states, although with considerable variation across sectors.

Over-estimating the effect of EU membership on FDI inflows?

Membership of the EU has two important implications with regard to FDI: First it allows countries that have small domestic markets to expand their de facto market size. Firms located in the EU have access to the entire EU. However, as the number of countries in the EU increases, this advantage is currently shared by 27 member countries (and in the future possibly by the three candidate countries as of 2008-Croatia, Former Yugoslav Republic of Macedonia and Turkey) and even more if one includes countries that have preferential access to the single market through various lesser forms of trade agreements. Thus, this advantage has considerably less value to the accession countries than it had for the cohesion countries, and this is exacerbated by the fact that domestic firms in many of the CEE countries have little experience in dealing with competition in a market economy, and thus further attenuate the benefits that derive from the competition effect.

Second, memberships suggest political, economic and legal stability. Although the absence of efficient institutions can retard the efficient accumulation and transfer of knowledge (e.g., Rodrik 1999, Rodrik, et. al. 2004; Meyer and Peng, 2005; Asiedu 2006) EU accession countries are not competing with the least developed countries for FDI. Indeed, it is a requirement for membership that candidate countries demonstrate convergence and overlap of formal and informal institutions. This acts as a location advantage vis-à-vis non-member countries with poorly developed institutions (say, Latin America, Russia) but not necessarily

so compared to non-members who are stable (for instance, some East Asian countries), or indeed relative to other long-standing EU members. Again, the greater the number of countries that are members, the less stability counts as a unique advantage to potential investors. For example, Fabry and Zeghni (2006) find that FDI in 11 former Communist countries is sensitive to *specific and local* institutional arrangements.

As such, EU membership *per se* does not necessarily lead to an increase in the quality or the quantity of FDI that a country receives, and this is best illustrated by the case of Greece. In 1980, inward FDI stock per capita was US$ 470 (all figures in current prices) compared with US$ 315 and US$ 137 for Portugal and Spain. By 2007, FDI stock per capita in Greece had grown to only US$ 4740, compared with US$ 10750 and US$ 12138 for Portugal and Spain respectively.

To take just one example from the NMS for comparison, Hungary's FDI per capita in 2007was already more than double that of Greece (US$ 9711). A substantial part of these flows took place *before* Hungary became an EU member in 2004. In this respect it is important to highlight that while EU membership may help promote FDI, we argue here that the positive effect of EU membership for FDI are decreasingly important, partly because these advantages are less significant as the number of EU members increases. Furthermore, globalization and the growth of supra-national agreements (particularly those associated with the WTO) mean that several of these benefits are not as unique as they once were. Firms from outside the EU are no longer "forced" into EU-based production since tariff and non-tariff barriers are fewer. It is worth remembering that a large part of the inward FDI flows from outside the EU prior to 1992 was spurred by the fear of 'Fortress Europe'. These fears have largely proven to be unfounded. Finally, the growth of peripheral trade and investment agreements with non-EU members also may impact on the effects of EU membership.

The point here is that the benefits that accrued from EU membership to the countries that joined earlier are substantially attenuated for later entrants to the EU because of globalization. First, because global financial, political and economic liberalization that forms a large part of the globalization process has 'levelled the playing field' in lowering the risk

associated with trade and investment in most parts of the world (Narula 2003). With growing technological convergence, increasing homogeneity of consumption patterns and improved communication and transportation facilities these factors have reduced the costs associated with supplying EU markets from East Asia or the Americas.

As such, many of the new entrants to the EU are faced with increased competition for FDI not just from other European countries but also from other parts of the world, most notably Asia. While the total flows of FDI are not fixed and thus *in principle* countries need not compete for FDI, since the volume of FDI depends on the level of domestic investment in the home countries. Therefore, FDI need not be a zero-sum game. Nonetheless, particularly when host countries are of a similar level of development, substitution effects may occur and hence they *de facto* compete for a limited amount of FDI.

The empirical evidence on the effects of EU membership and the shift from the cohesion countries to the NMS by and large confirms our sceptical view of FDI flows to the cohesion and accession countries. *Ex ante studies* on the effects of EU membership on the shift of FDI, not unexpectedly, have found a wide range of effects. These studies are mainly simulations based on theoretical models: As early as the mid-1990s, Lankes and Venables (1996), Baldwin et al. (1997), Brenton and DiMauro (1999), Pfaffermayr et al. (2001) and Galego et al. (2004) examined various aspects of the shift of FDI from the periphery to the CEE countries. Other papers (e.g. Gorg and Greenaway 2002) examined the FDI potential of the CEE countries upon accession. Altomonte and Guagliano (2003) go beyond the cohesion countries and examine the potential of the CEE countries compared to the Mediterranean region, which can be considered as a competitor location. Clausing and Dorobantu (2005) found significant effects of key European Union announcements regarding the accession process. Garmel et al. (2008) in a growth model predict that three-quarters of capital in the NMS will ultimately be acquired by investors from the 'core' member states in the long run. *Ex post studies* have generally found some, but no dramatic shift of FDI (see e.g., Buch et al. 2003; Meyer and Jensen 2003; and Kalotay 2006).

This increased competition for FDI challenges both the cohesion countries and the CEE countries. Many (but not all) of these countries have sought to compete globally on the basis of two primary location advantages: low labour costs and EU membership. As we have discussed above, EU membership is not as much of an advantage in a liberalized, stable and shrinking world where distance does not form as much of a barrier to trade and investment as it once did. For similar reasons, the low- cost advantage of these countries has also been dissipated in many cases, particularly where productivity gains in China and other Asian economies have grown (Kalotay 2004) partly as a result of their superior technological infrastructure. Spain and Portugal have experienced some displacement of FDI or lost sequential FDI because they have not been able to develop location advantages in knowledge- and capital-intensive activities to compensate for the rising labour costs that have eroded their industrial base in low value adding activities, a development that also has been observed in CEE countries, where already some production activities have been shifted "further East".

FDI and the cohesion countries: policy implications

In the light of the empirical evidence discussed in the previous section, in the case of Spain, Portugal and Ireland, we expect to see some level of displacement to the new members in industries where:

1. low-cost labour remains the primary reason for location and where the MNE subsidiary has not expanded its original low value adding activities towards knowledge intensive areas in which the domestic economy has a competitive advantage;
2. where the MNE subsidiary is not embedded through important linkages to other firms in the host economy; On the contrary, when the MNE subsidiary is located close to an important customer or supplier, and proximity is important (e.g., because of just-in-time delivery) it is unlikely that the firm will relocate.
3. where the sunk costs of an FDI in the host economy are low;
4. where productivity gains have overcome disadvantages associated with rising labour costs; and

5. where skill levels are not particularly high and thus employees are easy to substitute[3], since in these cases (tacit) know-how hardly limits the slicing of the value-chain.

In other words, the most obvious long-term solution for cohesion countries is to improve their location advantages in other areas, towards more science-based technological sectors. Ireland has succeeded in doing so with its focus on the ICT sectors (Barry 2004), although Portugal and Spain have so far failed to make significant moves towards more science-based sectors. Beyond the fact that science-based sectors and knowledge intensive activities fit the current comparative advantage of these countries much better, they are also less footloose. This is partly because these sectors tend to rely on location-specific and location-bound assets that are less easily substitutable.

Disinvestments in the cohesion countries are of course not happening suddenly, because although they do rely on cheap factor inputs, they are also capital intensive. They are also less footloose partly because they are in industries in which these host countries are firmly established locations within the major MNEs' global production networks. In each of these locations the MNE affiliates are well embedded in the local economy, and the specialized infrastructure to support this sector is well developed.

It is not immediately obvious that when MNEs begin to disinvest from the cohesion countries will automatically result in increased investments in the accession countries in the same industries. In the automobile industry for instance, the efficiency of a new greenfield plant tends to require a relatively large minimum efficiency scale. MNEs are reluctant therefore to start out in greenfield sites which is a further deterrent to setting up new investments in the CEE countries. Except where strong domestic sectors and specialized knowledge based clusters exist – whether public or private – the CEE countries are unlikely to receive major inflows of FDI that are intended to supply the EU as a single market.

[3] The EU KLEMS database, http://www.euklems.net/index.html, has detailed accounts for high-, medium- and low-skilled by industry for a large range of countries and for long time periods.

The lesson here for most peripheral countries is very much the same as one that development policy experts (see e.g., Rodrik 1999, Lall 1997b, 2004 and Haque 2007) have been arguing for the developing countries: dependence on static and generic location advantages – whether drawing from the development of institutions, infrastructure, stability, or low cost labour – is necessarily short term and short-sighted. The last two decades of increasing liberalization, falling transportation and communication costs and investment in knowledge-based activities in East Asia has meant that the peripheral EU countries are no longer as attractive (although it should be noted that the lack of strong IPR enforcement in some Asian countries does provide a small window of opportunity). It is axiomatic that as industrial development takes place, the comparative advantage of these countries needs to shift away from low value adding activities to higher value adding activities, which are necessarily science-based.

It is only in those sectors where 'specialized' location advantages associated with higher value adding exist can host countries benefit significantly from MNE activity in the long run. This requires a considerable amount of government interaction and investment into tangible and intangible infrastructure. As countries reach a threshold level of technological capabilities, governments need to provide more active support through macro-organizational policies. This implies developing and fostering specific industries and technological trajectories, such that the location advantages they offer are less 'generic' and more specific, highly immobile and such that they encourage mobile investments to be locked into these assets. Many of the CEE countries have the basis for creating such science based location advantages. For instance, Poland has strengths in certain natural and life sciences, as does Hungary in electro-mechanical sectors. The Czech republic has opted to focus on the automotive sector, given the existence of large automotive plants, while the Slovak republic has attracted a number of greenfield automotive plants. Of course, adapting to such challenges is not costless from three points of view. First, countries need considerable resources to invest in such vertical industrial policy actions. Second, they require considerable political will and discipline, because other industries will necessarily need to be 'wound down'. Third, fostering new sectors requires major institutional change. Innovation systems and firms designed, developed and ingrained within central-planning models and their associated institutional arrangements do not function effectively in a market economy

(Narula and Jormanainen 2008). Such radical systemic change requires resources and an effective period of transition given the inertia associated with in formal and informal institutions.

There are two points of caution that need to be raised here. First, in pursuing such a strategy, the peripheral EU countries face competition not just from Asia, but also from the 'core' economies of the EU which have systematically developed strengths in technology intensive sectors over decades, and can often out-compete weaker, peripheral economies in terms of resources, incentives and opportunities. Nonetheless, there are several niches and gaps in their technological competences that can be effectively exploited by the peripheral economies.

Second, such a strategy requires systematic long-term investment, both in terms of building up the appropriate public infrastructure, and in promoting domestic capacity in both supplier and related activities. Many of the CEE countries have well-trained and skilled work force, but the availability of a large stock of suitably qualified workers does not in itself result in efficient absorption of knowledge, or its efficient use in industrial development, especially, the much lower level of relevant infrastructure (Bellak et al. 2008) may deter FDI. Rather, this requires the presence of institutions and economic actors within the industry which defines the stock of knowledge in a given location, and the efficient use of markets and hierarchies, be they intra-firm, intra-industry or intra-country. This knowledge is not costless, and must be accumulated over time. Important externalities arise which impinge on the ease of diffusion and efficiency of absorption and utilization of external knowledge (Criscuolo and Narula 2008).

Industrial policy where certain industries are selected for rapid growth by focused investments through intensive development of created assets can and do accelerate economic development. The examples of both the more advanced industrializing countries (such as the Asian NICs) and emerging economies such as Malaysia and Brazil illustrate this. Attracting specialized FDI to a particular sector can alter the sequence of industrial upgrading (Williamson and Hu 1994), because specialized FDI may help improve the created assets

associated within a sector (say consumer electronics production). Created assets in this sector may have significant knowledge flows externalities in another (say micro-electronics design), which in turn may represent significant input to another sector (say software development). But this assumes the presence of a virtuous circle, and the development of appropriate clusters.

Specifically, for the CEE countries it is argued that both proactive and reactive policies are needed to achieve sustainability of FDI. Proactive policies are geared to attract FDI and therefore affect the sustainability via sectoral targeting. Reactive policies at making FDI more sustainable through three distinct policy channels, namely through strengthening comparative advantage; enabling firms to benefit from economies of scale; and supporting agglomeration forces. In this respect, emphasis should be put on providing specific bundles of location factors as public goods for closely defined value-added activities of the MNE. (Bellak and Leibrecht 2007, p. 234)

There is empirical evidence that a clear gap exists between “old” and “new” member states’ policies to attract additional FDI (Bellak et al. 2008b). The older member states gained most by focusing on infrastructure and R&D policies. ‘New’ member states’ policies have tended to focus on reducing the share of low-skilled workers (for example by encouraging firms to restructure production and increase capital intensity) and through a reduction of labour costs via a decrease in non-wage-labour costs. The fact that different policy areas are relevant in the two groups of countries opens the possibility for focused policy approaches geared to the needs of individual sectors.

FDI-assisted growth requires the capacity to be a ‘strategic follower’ (Ramos 2000). This requires a systematic understanding of what technological capabilities need to be developed or enhanced, and to seek to actively coordinate potential users with sources of the appropriate technologies. Asian governments that have pursued such a strategy successively have actively sought to identify, acquire and transfer technologies, with government agencies acting as market-makers. Left to their own means, firms have a tendency to be risk averse, and to avoid the financial and technological risk of upgrading their technological assets as

long as these continue to provide a reasonable rate of return. This short-term myopia is not unique to firms of any given nationality. Many governments recognize this problem, and seek to overcome or at least reduce the perceived risk levels by providing subsidized loans and other incentives to domestic firms that restructure their existing operations by adopting new technologies in the products and processes that promoted international best practice.

The countries with the most successful technological upgrading – Korea, Taiwan and to a lesser extent Brazil – allocated subsidies in what Amsden and Hikino (2000) and Amsden (2001) call a 'reciprocal control mechanism'. That is, incentives and subsidies whether to upgrade technologically, promote local content, expand exports or reduce import-dependence were subject to performance standards that were actively monitored, and in Amsden's (2001) words, were 'redistributive in nature and results-oriented' and acted to prevent government failure.

To be sure, upgrading of technological capabilities of domestic firms can no longer be pursued in quite the same way in a globalised world. International competition is a given, and there can be no return to the infant industry model (except for few particular industries). While a number of CEE countries have had considerable investment in R&D, a majority of the formal R&D efforts were conducted by state-owned enterprises and the non-firm sector. While the role of the state must necessarily remain a significant investor in innovation, these policies need to be orchestrated with the private firm sector, whether domestic or foreign. Given that the CEE countries prior to their EU membership have to accept the *acquis communautaire*, discrimination of domestic and foreign firms is no longer possible as stated in the competition policy regulations of the EU.

Market forces cannot substitute for the role of governments in developing and promoting a proactive industrial policy (Lall 1996, 1997a, 1997b, 2003). Firms necessarily take a shorter term, profit maximising view because they are largely risk averse. MNEs and unrestrained flows of inward FDI may well lead to an increase in productivity and exports, *but they do not necessarily result in increased competitiveness of the domestic sector or increased industrial capacity*, which ultimately determines economic growth in the long run. FDI *per se* does not

provide growth opportunities unless a domestic industrial sector exists which has the necessary technological capacity to profit from the externalities from MNE activity. Yet, as there are only very few domestic firms left in some industries in the CEE countries, this possibility of growth may be limited. This is also well illustrated by the inability of many Asian countries which have relied on a passive FDI-dependent strategy to upgrade their industrial development. It should be remembered that unrestrained FDI inflows often results in 'crowding out' of the domestic sector. FDI and domestic capabilities and a domestic sector need to be concatenated and properly phased if positive results are to be achieved. The lesson here is not that the role of governments should be substituted by the market, but that markets and governments can co-exist.

The lessons of developing countries cannot of course be applied without some modification to understanding the impact of FDI on the development strategies of the NMS and the cohesion countries. As we have emphasized here, there are additional layers of complexity that derive from 'deep' integration within such a powerful economic and political bloc. However, these are - by and large - positive, in the sense that 'insider' status within the EU provides a considerable boost to the location advantages of these countries, even if they are less significant than in previous rounds of EU expansion. The largest challenge is that of institutional restructuring, and the move – especially for the CEE countries – away from national champions and state-ownership of key sectors, and state-defined priorities, which has been achieved in the CEE economies to different degree, partly as a result of specific funds made available to these countries by the European commission. On the other hand, these countries are also limited by EU policies, particularly those associated with regulation, competition and state aid.

Specific challenges for the accession countries

Many of the new and accession member states have yet to confront the difficulty in embedding inward FDI into domestic economic and innovation systems and here is where the challenge lies. One of the challenges in creating embeddedness is associated with

matching the industrial structure and comparative advantage of the region[4] with the kinds of FDI that are being attracted. As highlighted in the previous sections, benefits from FDI are maximized when the kinds of investment projects being attracted are matched with the potential clusters of domestic competitiveness into which the MNEs may be able to tap into.

In the case of the accession countries, many have well-developed components of Science and Technology systems. Some are even endowed with considerable capacity in high value-adding activities such as R&D, software development and design. This has been used as a basis to attract and embed highly specialized, high competence MNE facilities[5]. Nonetheless, one of the considerable disadvantages these countries face is the challenge of dismantling of centrally planned innovation systems which are driven primarily by planners and bureaucrats rather than by demand conditions and the specific needs of firms. Such restructuring has to deal with considerable inertia in the institutional arrangements (Narula and Jormanainen 2008) which is often difficult to overcome.

Ceteris paribus, foreign affiliates interact with knowledge organizations like local universities and public research institutes, which undertake basic or applied research, produce R&D manpower and provide technical services to firms (see Chapter 7, UNCTAD 2005). Foreign affiliates may cooperate with these institutions, e.g. by providing financial support and conducting joint research projects. Such collaboration can also help R&D by other enterprises, by raising the research capabilities of knowledge institutions, bringing them into contact with industrial work and promoting spin-offs. At the same time, however, MNEs may also be locked into existing supplier relationships, partnerships and R&D networks in other locations and may be reluctant to seek to establish new associations with as-yet unproven local suppliers and universities. Indeed, as MNE increasingly seek to rationalize their activities, decisions about local linkages are not always made at the subsidiary level, but at the headquarters level, by comparing the various options available to the MNE globally. Thus governments need to create incentives for the MNE to consider local partners, and not expect these to happen 'naturally'. Since EU member states cannot

[4] Again, it should be noted that we do not aim at addressing issues of particular countries, but rather try to provide a sketch of the broader aspects.
[5] Kokko and Kravtsova (2007) provide case studies on these aspects.

discriminate by nationality of ownership, in the circumstances where domestic firms are not present, linkages between foreign affiliates and other foreign firms (but located and engaged in economic activity in the same host location) may represent the sole available mode of industrial upgrading and capability development in the CEE countries. As long as industrial and technological upgrading happens and spills over to more than one firm, it does not matter who the beneficiary is, as long as it serves to further embed the MNE affiliate in the host country.

Often, there may not be domestic firms and organisations that properly match the potential needs of the MNE, and this also requires government intervention. At one level, projects need to be led by investment by the government, by establishing science and technology incubators for small groups of industry-facing researchers who help bridge the research undertaken in public institutes to the commercial needs of MNE affiliates. It is important that the focus of these incubators is on the collaboration with MNE affiliates, and the provision of the infrastructure and environment to foster competitive R&D. At another level, it may also be necessary to create (and encourage the creation of) new, more nimble and entrepreneurial smaller firms, and not attempt to force a 'fit' between the older, large and former state-owned enterprises whose competences do not properly match the needs of the MNE affiliates. In the case of the accession countries, there has been a historical trend to focus on large firms, and the absence of special treatment for start-up firms and SMEs means that the bureaucratic red-tape prevents the establishment of such a policy.

The challenges that the accession countries face vis-à-vis developing countries are plainly easier in many ways, because membership does provide them with important location advantages. They have access to a much larger and more affluent market; valuable resources are made available by the EU to improve their basic infrastructure; they are obliged to converge their institutional arrangements to the EU standard; they are protected by EU regulation and laws; they have the political and economic clout of the EU in the areas of competition policy, trade policy, and so forth. However, they are also in the 'home region' of some of the world's largest MNEs, and thus face greater and immediate competition, and cannot afford to be passive.

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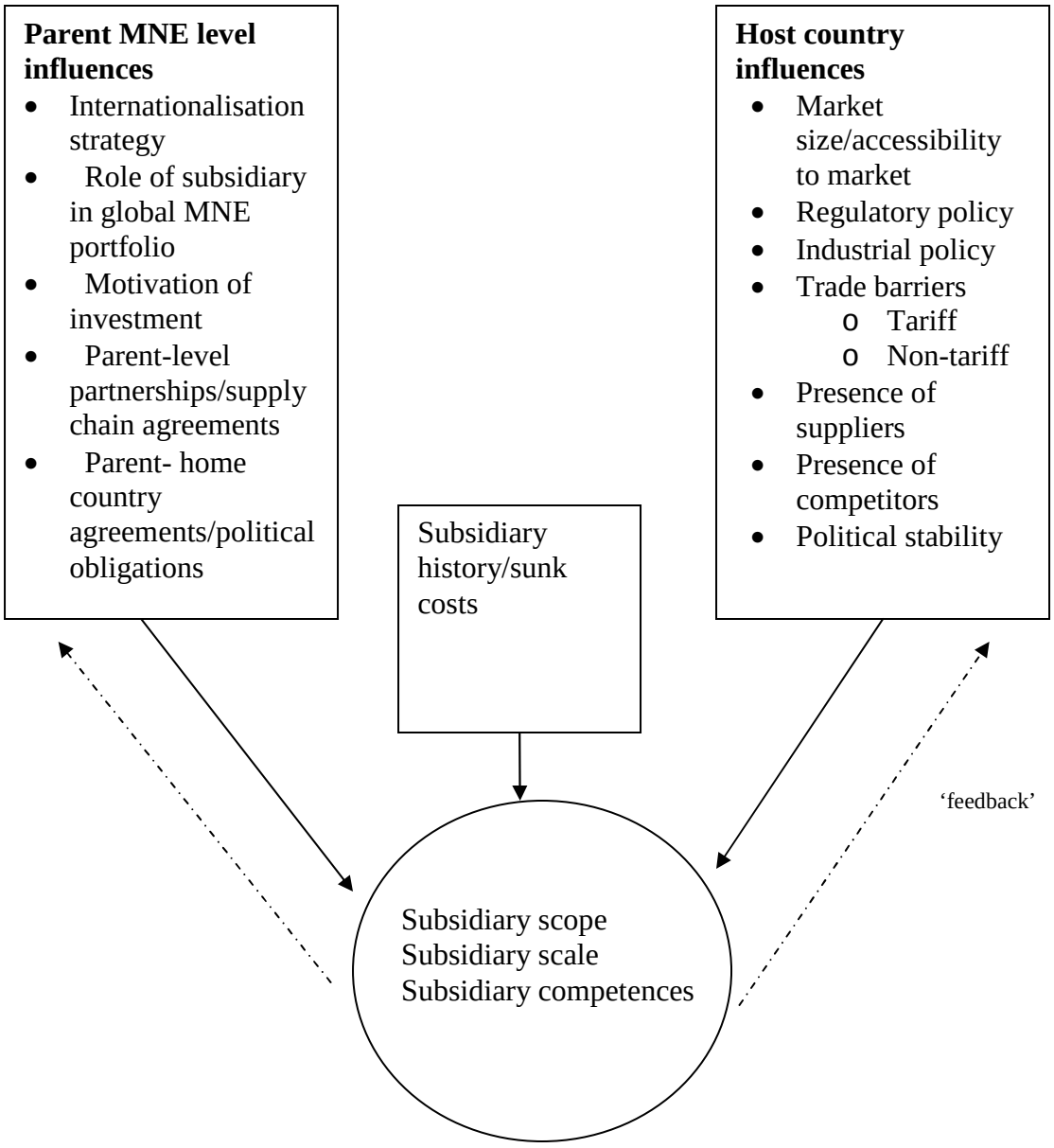
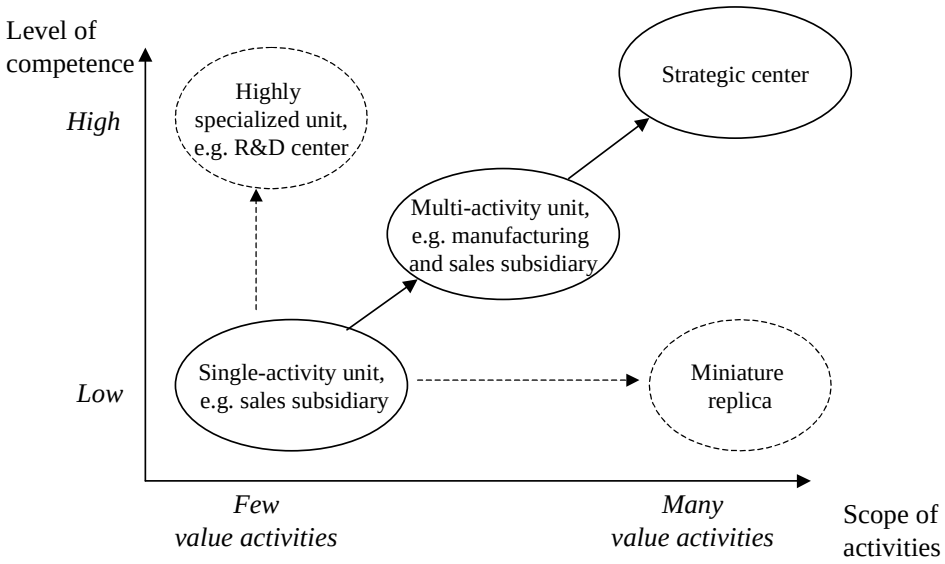


Figure 1: determinants of the competence, cope and scale of a foreign affiliate



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Source: Benito et al 2003

Figure 2 Different types of subsidiaries, and their relationship to scope and competence levels.

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